

# **PRIVATE EQUITY STATEMENT OF INVESTMENT POLICY FOR THE NEBRASKA INVESTMENT COUNCIL**

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## I. Revision History

<u>Action</u>	<u>Date</u>
Original approved and established.....	September 2007
Policy revised.....Draft.....	February 2009
Policy revised.....Draft.....	March 2009
Policy approved.....	March 2009

## II. Scope and History

This policy applies to the Private Equity funds of the Nebraska Investment Council (“The Council”). In 2005, the Nebraska Investment Council approved a recommendation to invest 5.0% of the Defined Benefit Plan and Cash Balance Benefit Plan assets in Private Equity in early 2005. The Council’s first investment step in Private Equity was to approve a long-term target allocation of 5.0% to this asset class, but purposely committed only a portion of the 5% allocation to allow The Council time to gain further experience and comfort with this asset class. As a result, two fund of funds managers were hired with commitments of \$100 million and \$50 million, respectively. Fully funded, the \$150 million commitment would represent less than 3.0% of defined benefit/cash balance benefit plan assets. The Council’s intent in not making a full commitment initially to Private Equity through funds of funds was to re-evaluate the allocation and to consider a strategy at a later date to fully implement the long-term target allocation of 5.0% (+/- 2.0%). In order to implement its investment strategy, The Council will use individual investment managers and fund of funds in certain circumstances.

## III. Purpose and Objectives

The purpose of this Private Equity Statement of Investment Policy is to formalize The Council’s investment objectives and policy with respect to the Private Equity asset class and to define the duties and responsibilities of the various entities involved in the Private Equity investment process. This statement is to be considered an extension of The Council’s overall Statement of Investment Policy. No provision of this Private Equity Statement of Investment Policy shall be construed in contravention of the enabling legislation found in the state’s pension code.

## IV. Investment Philosophy

The Council allocates a portion of its total assets to the Private Equity asset class. The Council defines its Private Equity asset class by investments made in the equity or debt securities of privately owned operating companies. The Council allocates assets to Private Equity with the following goals:

### *Diversification with Other Asset Classes*

Private Equity returns have historically performed differently than the returns of other asset classes in which The Council invests. The Council believes that Private Equity returns will continue to behave differently from other asset class returns, allowing The Council to lower the risk of its overall portfolio through diversification by allocating to the Private Equity asset class.

### *Return Enhancement*

Private Equity partnership total rates of return are expected to be greater than those that are expected from conventional equity investments. To help The Council portfolio's ability to outperform and produce excess returns, an allocation is made to the Private Equity asset class in these styles.

### *Current Income and Appreciation*

Certain debt and energy related Private Equity strategies have historically shown the ability to maintain a moderate current income component with a modest appreciation component. As such, an appropriate proportion of The Council Private Equity portfolio is targeted to be allocated to each of these strategies referred to as special situations.

## **V. Allocation**

The Council controls allocation risk at the plan level as shown below in Table 1. The allocation establishes a 5.0% (+/- 2.0%) target for Private Equity.

Table 1. Private Equity Target Allocations.

<u>Fund</u>	<u>Target</u>
Defined Benefit	5.0%
Cash Benefit Balance	5.0%
General Endowment	5.0%
Health Care Endowment	5.0%

Asset allocation is a critical driver for the long-term success of the Private Equity program. Standard portfolio theory suggests that asset allocation risk is managed by establishing target portfolio exposure parameters and optimizing the portfolio along risk and return expectations. Private Equity is not conducive to a rigorous quantitative approach and asset allocation risk is controlled through long-term subjective market value parameters.

Long-term market value targets are established below. The Private Equity portfolio will achieve diversification beyond geographic focus by investing in partnerships that are complementary in nature regarding fund size, sector and strategic focus.

Table 2. Private Equity Sub Sector Allocations and Ranges

<u>Sub Sector</u>	<u>Range</u>
Buyouts/Corporate Finance	40.0 - 50.0%
Venture Capital	up to 25.0%
Special Situations	25.0 - 40.0%

## VI. Performance Objectives

Private Equity performance is benchmarked against the Wilshire 5000 Index plus 300 basis points per annum for cash flows older than three years and against the pooled average return of Venture Economics for cash flows during the first three years.

Objective - long-term rates of return on investments.

1. To achieve long-term rates of return on alternative investments, net of fees and expenses, that meet or exceed the required rate of return on liabilities or other fund objectives and that meet or exceed market-based performance benchmarks without taking imprudent risk.
2. To achieve superior total returns when compared to traditional asset classes and to exceed the Wilshire 5000 Index (total time-weighted returns including dividends) by 300 basis points per annum in the long run.
3. To diversify away from traditional asset classes' capital market risks.

Time Horizon - Performance of the alternative investment assets against their return objectives will be measured over a full market cycle. Market cycles may differ markedly in length based on the type of investments made, and there is no standardized measure for a market cycle's term. The time horizon for alternative asset classes, by their nature, is longer than traditional asset classes. Most of the partnerships have lives ranging from ten (10) to twelve (12) years. Performance shortfalls relative to the return objectives for the alternative assets will be tolerated over portions of the market cycles, provided that the return objectives for the alternative assets are met over the full market cycle. Performance of funds that have been approved by The Council, but have not called capital, will be excluded from the performance analysis.

Diversification - Diversification of risk across a broad cross-section of funds and vintage years is a primary way that The Council will manage the riskier and illiquid nature of investments in alternative asset classes. The objective in each alternative asset class will be to achieve broad diversification by having access to a variety of sub-sectors, industries, and geographies throughout the portfolio.

Cashflows and Liquidity - Investments in alternative asset classes such as Private Equity are less liquid than traditional asset classes (public equities and fixed income). As a result, the management of cashflows into and out of alternatives must be carefully managed. Early in the investment cycle, there will be a negative cashflow as new investments and fees to managers on commitments exceed the cash that is being distributed from the investments in the form of income, appreciation or return of capital. It should also be noted that given the typical funding/distribution pattern of Private Equity funds, The Council will likely need to over-commit by a ratio of approximately 2 to 1. To achieve its target allocation of 5.0%, the Council may need to commit nearly 10.0% of its assets to Private Equity funds and funds of funds. Once The

Council's alternative investment allocation is fully funded, distributions will be redeployed in new opportunities to maintain target exposure to these asset classes and to rebalance if Private Equity is below or exceeds the target allocation.

Most of the structures that The Council will utilize in implementing its alternative asset strategy will have limited liquidity as compared to public securities. The Private Equity funds will draw down capital as transactions are funded and distribute proceeds as transactions are liquidated.

Other Considerations - After The Council's allocation to Private Equity is fully funded, it is expected that cashflows from distributions will be reinvested in the asset class to maintain full funding of allocations and to rebalance if the asset class is above or below its target allocation.

## **VII. Permissible Investments**

The majority of the allocation to the Private Equity asset class should consist of equity ownership of privately- held institutional Private Equity investments. A portion of The Council's private markets Private Equity assets may also consist of non-equity investments (e.g., senior and subordinated debt, mezzanine financing, preferred equity, options and warrants).

This policy authorizes the use of all investment types, including:

### **Corporate Finance/ Buyouts**

(40% to 50% allocation) – Partnerships which provide funding to acquire majority or controlling interests in a business or product lines from either a public or private company. These partnerships are generally diversified by industry and other relevant measures. Buyout partnerships cover company size ranges from mega to small-market.

- Classification by Fund Size
  - Small Buyout                      \$0-500 million
  - Medium Buyout                      \$500 – 1,000 million
  - Large Buyout                      \$1,000 – 5,000 million
  - Mega Buyout                      \$5b +
  
- Classification by Total Enterprise Value
  - Small Buyout                      \$0-100 million
  - Medium Buyout                      \$100 – 1,000 million
  - Large Buyout                      \$1,000 – 3,000 million
  - Mega Buyout                      \$3b +

### **Venture Capital**

(up to 25% allocation) – Investments in newer high growth companies typically addressing technology, life sciences and other specialty growth industries. Venture Capital partnerships will

be allocated into three categories and The Council will endeavor to select partnerships that represent the strategies in the appropriate amounts and diversity.

- Seed – An entrepreneur has a new idea or product, but no established organization or structure. Investors tend to provide a few hundred thousand dollars and perhaps some office space to an entrepreneur who needs to develop a business plan.
- Early Stage – The organization has been formed and has employees, and products are in the developmental stage. Early-stage investors back companies when they have a completed business plan, at least part of a management team in place, and perhaps a working prototype.
- Later Stage – An established infrastructure is in place, and the company has a viable product that is market-ready and generating revenues. Later-stage investors typically provide financing for expansion of a company that is producing, shipping, and increasing its sales volume.

### **Special Situations**

(25% to 40% allocation) Partnerships with private corporate finance investment strategies that do not fall under the prior two categories or do not justify a separate long-term strategic allocation. The Council will seek to diversify the portfolio across various sub-strategies. Examples include:

**Distressed Debt/Turnaround:** Investments made in distressed or poorly performing companies, with the intent of initiating a recovery via financial restructuring or the introduction of management expertise. Partnerships investments may include debt and/or equity securities.

**Subordinated Debt (Mezzanine):** Partnerships that make debt-related investments in unsecured or junior obligations in financings. These generally take the form of subordinated debentures or preferred stock. They typically earn a current coupon or dividend and have warrants on common stock or conversion features.

**Hybrid Partnerships:** Funds that have broad strategy mandates and may invest materially in non-control investment structures or a variety of strategies that would preclude a simple venture capital or buyout categorization.

**Industry Specific:** Funds that target a specific industry (e.g., healthcare, energy, financial services, media and communications, etc.). These funds may be considered as having greater industry specific risk than more diversified buyout funds.

**Other:** There are on occasion Private Equity partnerships that pursue strategies different from those cited above (i.e., secondary purchase, market dislocation, first time fund) that The Council may, in its discretion, seek to participate.

## VIII. Risk Management

For Private Equity investments, the following sections identify the most significant risks and the method of control. Compliance with the following risk parameters shall be based on % of the Private Equity portfolio's Net Asset Value or Fair Value as of each quarter end.

### 1. *Investment Type*

The Council seeks to minimize the risk of its Private Equity portfolio by allocating its assets across the spectrum of sub sectors.

#### Allowable Range of Total Private Equity Allocation

Corporate Finance/ Buyouts	40-50%
Special Situations	25-40%
Venture Capital	up to 25%

### 2. *Geographic*

The Council seeks to minimize the risk of its Private Equity portfolio by allocating its investments across the geographic spectrum. No more than 35% of the Private Equity portfolio may be invested outside of the US.

### 3. *Manager*

Manager risk consists of two elements: the exposure to a manager and the number of managers in the Private Equity portfolio. To control manager exposure, the allocation to a single Private Equity manager is limited to 20% of the Private Equity allocation.

### 4. *Industry*

Industry exposure will be controlled through appropriate diversification across a broad cross-section of funds which focus on specific industries and through commitments to funds whose objectives include industry diversification objectives. No more than 30% of the Private Equity portfolio may be invested in any single industry.

### 5. *Life Cycle*

Most Private Equity funds will have life cycles between 10 and 12 years. Fund of funds may have a lifespan up to 15 years.

### 6. *Leverage*

The Council allows its managers to use leverage in their investment strategy as a means of enhancing the overall risk-adjusted returns available to The Council. Managers invest capital from Private Equity partnerships throughout the capital structure of firms. The capital markets control the maximum leverage available to the general partners. The Council will control leverage exposure through partnership selection and portfolio construction.

7. *Currency*

The Council accepts there are currency risks consistent with investments outside the United States.

8. *Liquidity*

Private Equity investments are illiquid and typically have expected holding periods of 10-12 years. Investments are typically held until maturity and selling prior to maturity typically results in a discount to fair market value. As such, The Council understands and recognizes that the Private Equity asset class will not be structured in a way to provide liquidity for the overall portfolio. Should market values for Private Equity change such that the asset class falls out of compliance with these guidelines, all avenues of remedying the violation will be evaluated and monitored by the consultant and The Council's Staff, but no action will be required to be taken to rebalance if it is believed that the forced sale will result in adverse economic impact to the overall Private Equity portfolio.

## **IX. Investment Manager Selection**

In order to implement its investment strategy, The Council will use individual investment managers and fund of funds in certain circumstances. The Council has a responsibility to its constituents to make investments with the objective of obtaining superior total long-term rates of return, while using acceptable levels of risk and reasonable cost controls. The availability of qualified minority and women-owned business enterprises is recognized by The Council. The characteristic of being a minority or woman-owned business enterprise is not a barrier to employment by The Council.

It is the policy of The Council to include qualified minority and women-owned business enterprises in the investment manager selection process, and to objectively evaluate all qualified investment manager candidates regardless of race, gender, or handicap.

The Council will evaluate all qualified investment manager candidates with emphasis on demonstrated track record performance, organizational depth, fit within the Private Equity portfolio, institutional investment management capability and experience, investment process, and reasonableness of fee structure and terms, regardless of the amount of investment assets under management or the age of the investment management firm.

The Council may use professional consultants that do not use discriminatory practices in the creation and maintenance of their investment manager databases, and may require the consultants to affirm their use of non-discriminatory practices when recommending investment manager candidates to The Council.

## **X. Distinction of Responsibilities**

The Council is responsible for approving the Private Equity Statement of Investment Policy.



The Council is responsible for selecting the investment managers used to implement the Private Equity Statement of Investment Policy.

The Council Staff is responsible for recommending investment managers to The Council, as well as for managing the Private Equity asset class and monitoring the investment managers, as described by the Private Equity Statement of Investment Policy on an ongoing basis.

The Council Staff may retain a Consultant to assist in selecting and monitoring investment managers, as well as to present the performance of the Private Equity asset class to The Council. The Consultant may also assist the Staff in developing and recommending any changes to the Private Equity Statement of Investment Policy.

Investment managers are used by The Council to implement the specific investment strategies selected by The Council.

#### **XI. Reporting and Monitoring**

The Council's Staff and the Consultant will monitor performance and compliance of the Private Equity asset class on a quarterly basis.

Adopted March 31, 2009